BOX 4. REASONS BEHIND INSUFFICIENT GENERAL GOVERNMENT TAX REVENUE

The tax revenue-to-GDP ratio in Lithuania is one of the lowest in the EU. Although the GDP share which gets redistributed in the general government budget during "normal" times mostly depends on public choices, when comparing different countries, there is a noticeable trend that the ratio of public spending (as well as of revenue, as it needs to be financed) and the GDP increases along with the country's economic development. This trend, also known as Wagner's law[16], means that the elasticity of goods and services provided by the general government in terms of average personal income is high: with the growing development levels and living standards, demand for goods and services provided by the state (e.g. social security, education, culture, infrastructure) grows even faster, resulting in the rising share of general government expenditure relative to GDP. With improving living standards in Lithuania (with an increase in GDP per person), the tax revenue-to-GDP ratio remains one of the lowest in the EU (amounting to around 30% of GDP). Therefore, in case of relatively small tax revenue in the general government budget, as compared to GDP, there is a risk that an adequate financing of state services and, in turn, their quality will not be ensured. In addition, a small budget limits the possibilities for reducing income inequality and poverty, and makes it more difficult to tackle long-term problems, such as an ageing population or implications of climate change. Insufficient tax revenue in the public sector is caused by various reasons. Several of them are discussed below.

The low tax revenue-to-GDP ratio is mainly determined by significant tax disparities resulting from the shadow economy, tax evasion as well as various tax exemptions and reductions. Failure to collect VAT is particularly related to the large-scale shadow economy. According to the latest data, Lithuania's VAT gap in 2018 amounted to around 30% of the total theoretical[17] VAT receipts and was one of the largest in the EU. The total potential additional income from VAT amounts to around €2.1 billion or 4.6% of GDP. According to the EC calculations, the compliance gap comprised the largest share of the VAT gap (2.7% of GDP, or over €1.2 billion), resulting mainly from the vast shadow economy, VAT avoidance and evasion. The policy gap comprised another share of the VAT gap, out of which the gap due to reduced tariffs was rather small (€272 million, or 0.6% of GDP)[18]. The progress made in the reduction of the VAT gap has so far been rather limited. In 2010–2018, Lithuania managed to reduce the VAT compliance gap by around 2 percentage points, which is much less than in other new EU countries[19].

Not all tax exemptions and reductions are appropriate. According to conducted research, support to lowest-income earners through a reduced VAT tariff is limited and a lower VAT tariff for separate sectors most often has only a temporary effect.[20] A reduced tax tariff which is applied to heating and hot water

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[16] Magazzino C., Giolli L., Mele M. (2015), "Wagner's Law and Peacock and Wiseman's Displacement Effect in European Union Countries: a Panel Data Study", *International Journal of Economics and Financial Issues*.

[17] The VAT gap shows the difference between the actual tax revenue from VAT and the "theoretical ideal" revenue from VAT which would be collected if the same tax tariff was applied to all goods and services and taxpayers perfectly complied with the law. Theoretical VAT revenue is calculated by multiplying the theoretical tax base by the tax tariff. For more on the VAT gap, see Annex 3 of the Lithuanian Economic Review, June 2018.

[18] The exemptions gap makes up a major share of the policy gap. It appears due to the fact that certain services are VAT exempt, such as financial, insurance, gambling and other services as well as, in some cases, real estate sales and some services of public interest, e.g. healthcare, social, education, culture, sports and other services. The majority of VAT exemptions related to the policy gap are established in the EU VAT Directive (2006/112/EC), therefore, it may not be possible to eliminate or significantly decrease the gap related thereto.

[19] Countries that joined the EU after 2004.

[20] See, for example, Benzarti Y., Carloni D. (2019), "Who Really Benefits from Consumption Tax Cuts? Evidence from a Large VAT Reform in France", *American Economic Journal: Economic Policy* 11, 38–63.

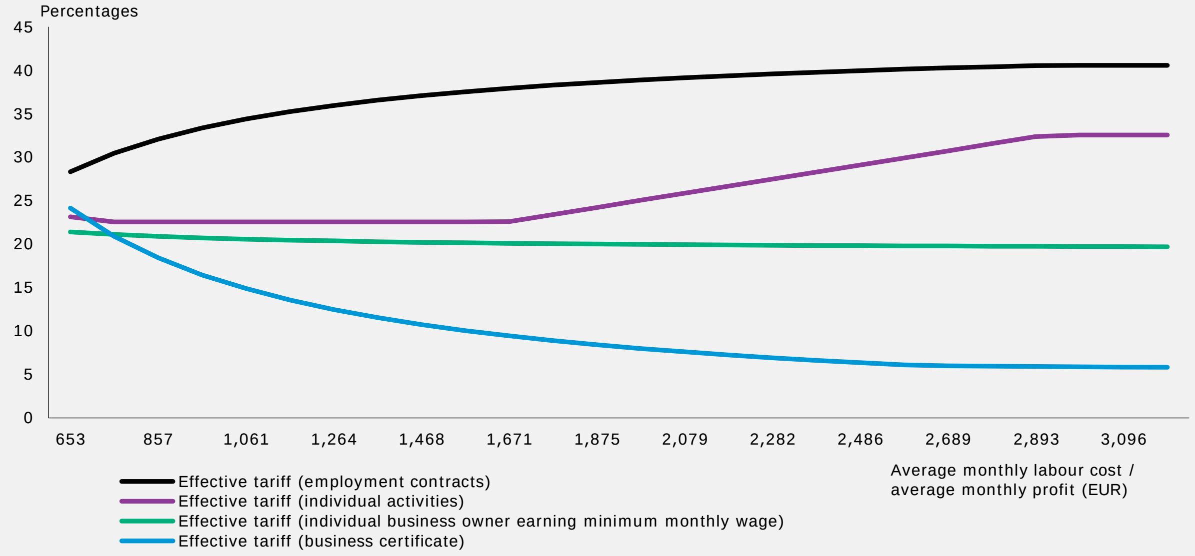
in Lithuania can be given as an example, as both low-income and high-income households benefit from it, while the loss of state revenue is rather significant (around €38 million, or 0.1% of GDP). More effective support for lowest-income earners is targeted benefits and a progressive income tax. Certain reduced taxes not only result in lower budget revenue but also increase pollution, the costs of which are borne by society as a whole (e.g. tax exemptions on fossil fuel). According to the draft budget for 2021, a total of around 4.2% of GDP in tax revenue is not collected due to tax exemptions.

The major share of insufficient tax revenue results from excess diversity in business forms and uneven taxation on personal income according to activity type. The horizontal principle of equality states that persons in a similar socio-economic situation should be taxed in a similar way, as they have equal opportunities to assume tax obligations, thus the applicable tax tariff should not depend on the type of income received or the activity type. Effective taxes imposed on self-employed persons in Lithuania are significantly lower than those applicable to persons working under employment contracts, and the tax burden depends on the activity type (see Chart A). It is important that a lower effective tax tariff applicable to self-employed persons is also determined by lower social contributions. Such arrangement does not ensure adequate social guarantees and will result in lower economic welfare in old age or in case of a job loss. These differences in social insurance become particularly noticeable during recession when persons without social insurance are at a higher risk of losing a source of income or earning significantly less, and these flaws of the social system are then fixed with ad hoc measures. The need for such measures also arose during the COVID-19 pandemic, along with the introduction of the new type of benefits, e.g. persons not subject to regular unemployment insurance were paid a benefit during the job-search period. It is also possible that in the future pensions of those who paid lower social contributions will be increased due to political pressure, without taking into account the contributions that were previously paid, and this will further diminish justice between persons paying different contributions.

Previous studies[21] show that income of self-employed persons (as their main activity) is of a similar level or even higher than that of those working under a contract, but self-employed persons pay relatively less taxes, as compared to those employed under a contract. Particular significant differences can be observed between those receiving the highest income, where the share of the self-employed is more concentrated and differences in effective tax tariffs are substantial. This creates legal and illegal incentives to choose such type of activity, the income of which would be subject to as low tax tariffs as possible and increase the possibilities for tax arbitration.

[21] Černiauskas N., Jousten A. (2020), “Statutory, Effective and Optimal Net Tax Schedules in Lithuania” Bank of Lithuania, *Working Paper Series*, No 72.

Taxation on personal income is uneven.
Chart A. Effective taxation tariffs on different types of activity



Sources: State Tax Inspectorate, Sodra and Bank of Lithuania calculations.

The relatively low tax revenue-to-GDP ratio is also determined by rather low general government revenue from property and environmental taxes. Revenue from indirect taxes in Lithuania, i.e. from VAT and excise taxes, comprises a much larger share of tax revenue than the EU average. Tax revenue from VAT amounts to around 26% of total tax revenue and social contributions in Lithuania, whereas in the euro area it stands at 17%. VAT is generally considered a regressive tax, as lower-income households tend to spend more for consumption than higher-income households. Therefore, VAT, as a consumption tax, creates a bigger tax burden. In view of this, the share of direct taxes should increase in the tax revenue structure. For example, in Lithuania, as compared to other EU Member States, there is a narrow tax base and low general government revenue from property and environmental taxes. Only a small share of the country's housing stock is subject to the real estate tax, thus in order to achieve a more effective taxation on capital and higher budget revenue from this tax, it would be useful to improve the framework of real estate taxation and extend the taxable base. Revenue from environmental taxes also needs to be increased, as it would not only be an additional source of income, but could also fix some market flaws, for example, pollution.